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Section 311(d) of the Internal Revenue Code, Earnings and Profits and Their Relation to Section 1248 Transactions

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Section 311(d) of the Internal Revenue Code, Earnings and Profits and Their Relation to Section 1248 Transactions

I. INTRODUCTION

The Tax Reform Act of 1969¹ provides in part that contrary to the ordinary rule, a corporation must recognize gain when it distributes appreciated property to a shareholder in certain stock redemptions.² In such stock redemptions, the taxpayer stockholder normally is accorded capital gain and loss treatment with respect to the stock redeemed,³ but if the redeeming corporation is a controlled foreign corporation and the transaction is governed by section 1248, a United States shareholder is taxed at ordinary income rates on his realized gain to the extent of the foreign corporation's earnings and profits. Any gain which exceeds the foreign corporation's earnings and profits receives the normal capital gain treatment. Before the 1969 Act a controlled foreign corporation with no earnings and profits could distribute appreciated property in a redemption of its stock with capital gain treatment as the only taxable consequence to the United States stockholder. This Note will explore the possible effects that the new section 311(d) will have on section 1248 and the foregoing transaction.

II. SECTION 311(d)

A. GENERAL APPLICATION

Section 311(d) is intended to prevent the loss of substantial revenue when a corporation acquires its stock with appreciated property.⁴ The general rule of section 311 is that a corporation does not realize gain when it distributes appreciated property as a dividend or in redemption of stock.⁵ Under section 311(d), if a corporation distributes appreciated property (i.e., fair market value exceeds adjusted basis) in a redemption, the corporation will recognize gain in an amount equal to the appreciation in value of the distributed property.⁶

1. Pub. L. No. 91-172 (Dec. 30, 1969).

2. Pub. L. No. 91-172, § 905(a) (Dec. 30, 1969). This provision of the 1969 Act added section 311(d) to the Internal Revenue Code of 1954. [Hereinafter only the applicable provisions of section 311(d) will be cited].

3. INT. REV. CODE OF 1954, § 302 [hereinafter cited as I.R.C.].

4. S. REP. NO. 552, 91st Cong., 1st Sess. 279 (1969).

5. See I.R.C. § 311(a)(2).

6. I.R.C. § 311(d)(1). The section applies with respect to distri-

It is evident from the committee reports that section 311(d) is aimed principally at insurance companies which hold large investment portfolios of appreciated stock.⁷ An insurance company could acquire its own stock by offering portfolio stock to its shareholders. The company could then either retire the redeemed shares or use them for reinvestment. The general problem to which the new section is addressed is that of large corporations redeeming substantial amounts of their stock with untaxed appreciated property thereby accomplishing the same monetary effect as if they had sold the property and redeemed the stock with the taxable cash proceeds from the sale.⁸

The new provision does not apply to distributions in partial or complete liquidation of the corporation, nor does it apply if there is no surrender of stock.⁹ The provision is also inapplicable to distributions in complete termination of the interest of a stockholder owning at least ten percent of the stock, and distributions of stock of a 50 percent or more owned subsidiary.¹⁰ Distributions pursuant to an antitrust decree, redemptions under section 303 to pay death taxes, certain redemption distributions to private foundations and distributions by regulated investment companies are also excepted from section 311(d) (1).¹¹

B. EFFECT OF SECTION 311(d) ON THE CORPORATION

Prior to the enactment of section 311(d), the general law with respect to corporate distributions of appreciated property, irrespective of whether the distribution was characterized as a dividend or redemption, was that the distributing corporation did not recognize gain or loss on the transaction. Certain exceptions and limitations were enacted to alleviate the loss of revenue created by the corporation distributing its appreciated property in lieu of selling it and distributing the cash proceeds.¹² The

butions made after November 30, 1969. Pub. L. No. 91-172, § 905(c) (Dec. 30, 1969).

7. H.R. REP. No. 413, 91st Cong., 1st Sess. 61 (Part 2) (1969).

8. *Id.* Note the tax consequences of the two transactions. When property is sold and the cash proceeds are distributed in redemption, the corporation realizes taxable income from sale, ordinary or capital gain depending upon the nature of the property sold; the shareholder enjoys capital gain treatment. When the appreciated property is itself distributed in redemption, normally there are no tax consequences to the corporation because of section 311(a), and the shareholder retains capital gain treatment of the redemption.

9. I.R.C. § 311(d) (2).

10. *Id.*

11. See CCH 1970 STAND. FED. TAX REP. ¶ 9051R.

12. I.R.C. § 311(a) refers to exceptions provided by I.R.C. § 311

new provision adds to these exceptions and reinstates double taxation with respect to most redemptions of stock: once at the corporate level and once at the shareholder level. Presumably the gain recognized under section 311(d) will be capital or ordinary depending on the nature of the property distributed.¹³ The corporation's earnings and profits account will also be increased by the amount of gain includable in the corporation's gross income under section 61 of the Code.¹⁴

C. EFFECT OF SECTION 311 (d) ON THE SHAREHOLDER

A shareholder who sells stock to a third party is normally afforded capital gain treatment.¹⁵ When a corporation redeems its stock with money or other property, the transaction may resemble an ordinary arm's length sale of stock to a third party, or it may more closely resemble the receipt by the shareholder of a corporate dividend.

If the transaction is treated as a corporate dividend to the shareholder, as distinguished from a redemption, the shareholder receives ordinary income treatment to the extent of the corporation's earnings and profits.¹⁶ If, on the other hand, the transaction is treated as a bona fide purchase by the corporation of its own stock, the shareholder realizes capital gain to the extent that the value of the amount received by him exceeds his basis in the redeemed stock.¹⁷ Thus, the only possible effect that the corporate recognition of gain under section 311(d) could have on the shareholder in a domestic corporation is that the increased corporate earnings and profits could result in subsequent dis-

(b) (LIFO inventory), I.R.C. § 311(c) (liability in excess of basis) and I.R.C. § 453(d) (installment obligations).

13. I.R.C. § 311(d) (1) specifically provides that the amount of gain shall be recognized "as if the property distributed had been sold at the time of the distribution."

14. I.R.C. § 61; Treas. Reg. § 1.312-6(b) (1955).

15. *But see* I.R.C. § 1236(a).

16. I.R.C. § 301(c) (1). If the amount distributed to a shareholder (money plus fair market value of any property) exceeds the corporation's earnings and profits, it is applied against and reduces the adjusted basis of the shareholder's stock. I.R.C. § 301(c) (2). Any excess after total elimination of basis is treated as a capital gain. I.R.C. § 301(c) (3).

17. I.R.C. §§ 302(a) & 1001. *See also* I.R.C. § 1222. This assumes that the stock redeemed is a capital asset in the shareholder's hands. If the amount of distribution is less than the shareholder's basis, such amount is first applied to reduce his basis in the stock and the excess, if any, is treated as a capital loss. *See* Guardino, *Tax Implications of Corporate Redemptions*, 9 TAX COUNSEL Q. 1 (1965).

tributions being treated as ordinary income.¹⁸ The situation is not the same, however, when a controlled foreign corporation redeems stock owned by a United States person and the transaction is governed by section 1248. There, the application of section 311(d) may have important implications.¹⁹ It is necessary, however, to develop a definition of the term earnings and profits in the present context before the interaction of sections 311(d) and 1248 can be understood. Thus, the following material, treated at some length, will provide a model upon which a proposed solution to the tangle between sections 311(d) and 1248 may be patterned.

III. THE CORPORATE EARNINGS AND PROFITS ACCOUNT

A. COMPUTATION OF EARNINGS AND PROFITS

1) *In General*

Although it frequently employs the term, the Code fails to provide a precise definition of earnings and profits or how to compute them.²⁰ This computation is necessary to permit a determination of whether corporate distributions are dividends, to be taxed as ordinary income to shareholder distributees, or to be treated as a return of capital or as a capital gain.²¹ It is also necessary to determine whether gain realized from a section 1248 transaction will be taxed at ordinary income rates to the United States stockholder.

The Code and the Regulations are able to state the effect of certain transactions on "earnings and profits" without ever having defined the term.²² The lack of statutory specificity has left the job of determining the meaning of earnings and profits to the courts and the Commissioner of Internal Revenue. They too have failed to develop a precise definition, but have merely managed a framework within which to proceed.²³ It is generally

18. See generally I.R.C. §§ 301 & 316.

19. See text at part IV *infra*.

20. I.R.C. § 312; Treas. Reg. § 1.312 (1955). See Zarky & Biblin, *The Role of Earnings and Profits in the Tax Law*, 18 S. CAL. TAX INST. 145, 146 (1966).

21. I.R.C. § 301(c)(2) (return of capital); I.R.C. §§ 301(c)(3)(A) & 302(a) (capital gain treatment).

22. I.R.C. § 312. See Treas. Reg. § 1.312 (1955).

23. "Among the items entering into the computation of corporate earnings and profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 61" Treas. Reg. § 1.312-6(b) (1955).

felt that "accumulated earnings and profits" roughly correspond to the earned surplus account on a corporation's balance sheet and that "current earnings and profits" roughly correspond to the net taxable income on a corporation's profit and loss statement.²⁴ In any event, the concept of earnings and profits is a creation of the tax law which always must be computed separately.²⁵

Generally, earnings and profits start with a corporation's net taxable income, including certain items excluded from the taxable income²⁶ and certain items deducted in computing taxable income,²⁷ and subtracting certain items that cannot be deducted in computing taxable income.²⁸ The earnings and the profits are computed at the close of the taxable year and without diminution for distributions made during that year.²⁹

2) Effect of Section 311(d)

The Code provides that the gain or loss realized from sale or other disposition of property by the corporation increases or decreases earnings and profits only to "the extent to which such a realized gain or loss was recognized in computing taxable income under the law applicable to the year in which such sale or disposition was made."³⁰

When a corporation distributes appreciated property in redemption of its stock under section 311(d), it must recognize as gain the amount by which the fair market value of the property

24. "[E]arnings and profits' in the tax sense . . . does not correspond exactly to taxable income [and] does not necessarily follow corporate accounting concepts either." *Comm'r v. Wheeler*, 324 U.S. 542, 546 (1945). See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 156 (2d ed. 1966).

25. Zarky & Biblin, *supra* note 20, at 147.

26. *E.g.*, interest on federal, state and municipal obligations and compensation for injuries or sickness. See B. BITTKER & J. EUSTICE, *supra* note 24, at 156-59.

27. *E.g.*, corporate dividends received must be included in full. See B. BITTKER & J. EUSTICE, *supra* note 24, at 159-60.

28. *E.g.*, federal income taxes and "excess" charitable contributions. See B. BITTKER & J. EUSTICE, *supra* note 24, at 160-62. An oversimplified formula for computing current earnings and profits is to add the corporation's taxable income and its nontaxable income, and subtract nondeductible expenses and federal income taxes. See Zarky & Biblin, *supra* note 20, at 147.

29. I.R.C. § 316(a) (2).

30. I.R.C. § 312(f) (1). See Edelstein & Korbel, *The Impact of Redemption and Liquidation Distributions on Earnings and Profits: Tax Accounting Aberrations Under Section 312(e)*, 20 TAX L. REV. 479, 510 (1965).

distributed exceeds its adjusted basis in the hands of the distributing corporation. If the corporation had first sold the appreciated property and then redeemed its stock with the proceeds, it is clear that the gain from the sale would be included in earnings and profits to the extent to which the realized gain is recognized as part of the corporation's taxable income for the year of the sale.³¹ Since recognized gain from the sale would have increased corporate earnings and profits, the gain recognized by a corporation under section 311(d)(1) properly increases the account also.³²

The 1969 Act also amended section 312(c)(3) to include section 311(d).³³ Since the earnings and profits of a corporation are adjusted by the gain recognized under section 311(d),³⁴ any gain recognized by the corporation under 311(d) would be included in the corporation's earnings and profits before the general rule of section 312(a) regarding the decrease of a corporation's earnings and profits is applied.³⁵ This apparent simultaneous increase and decrease in the earnings and profits account, however, can have substantial tax consequences to an individual shareholder if the corporation has no other earnings and profits.³⁶

B. EFFECT OF CORPORATE DISTRIBUTIONS ON EARNINGS AND PROFITS

1) *Tax Consequences to Individual Shareholders*³⁷

In a redemption treated as a "sale" or "exchange,"³⁸ the distribution of money or other property is treated as payment by the corporation in exchange for its stock.³⁹ Normally the redeemed stock is a capital asset in the hands of the shareholder and therefore he receives capital gain or loss treatment.⁴⁰ A

31. *Id.* Treas. Reg. § 1.312-7(b) (1955).

32. "[G]ain shall be recognized to the distributing corporation . . . as if the property distributed had been sold at the time of the distribution." I.R.C. § 311(d)(1).

33. "312(c)(3) [is] amended by striking out 'subsection (b) or (c)' and inserting in lieu thereof 'subsection (b), (c) or (d).'" Pub. L. No. 91-172, § 905(b)(2) (Dec. 30, 1969).

34. I.R.C. § 312(c)(3).

35. "[I]n a redemption . . . the part of such distribution which is properly chargeable to capital account shall not be treated as a distribution of earnings and profits." I.R.C. § 312(e).

36. The Regulations add vague support to this analysis. See Treas. Reg. § 1.312-3 & 4 (1955).

37. The tax consequences with respect to corporate shareholders is beyond the scope of this Note.

38. See I.R.C. § 302(a).

39. See I.R.C. § 317(b).

40. See Bittker, *The Taxation of Stock Redemptions and Partial*

"redemption" which fails to qualify as such under section 302 is treated as a section 301 distribution of property.⁴¹ If so treated, the computation of earnings and profits is essential to determine the amount of the distribution that will be taxed at ordinary income rates.⁴²

If a corporate distribution is treated as a "dividend"⁴³ to the distributee shareholder, the entire amount of the money and the fair market value of other property received is includible in the shareholder's ordinary income to the extent of the corporation's earnings and profits and the excess, if any, is treated as a return of capital.⁴⁴ To the extent that the distribution exceeds the

Liquidations, 44 CORNELL L.Q. 299 (1959). But see text at section B of part IV *infra*.

41. Treas. Reg. § 1.302-1 (1955).

42. Corporate distributions are deemed to have been made out of the most current earnings and profits first and then from the most recently accumulated earnings and profits. See Treas. Reg. § 1.316-2(a) (1955). For example, on June 30, 1969, corporation X makes a \$1,000 dividend distribution to its shareholders. On January 1, 1969, X had accumulated earnings and profits of \$500. However, X had a \$365 deficit in current earnings and profits, which unless otherwise shown is prorated over the entire current year at \$1 per day. Since there are no current earnings and profits, one must look to the accumulated account as of June 30, 1969, the date of distribution, to ascertain that amount of the distribution subject to dividend treatment. As of June 30, 1969, X's accumulated earnings and profits amounted to \$319 (\$500 minus \$181 for the prorated deficit of 1969). Thus of the \$1,000 distribution, \$319 is taxed as a dividend (ordinary income treatment) and the remaining \$681 will be either a return of capital or capital gain. However, if it were shown that as of June 30 corporation X had earnings of \$1,000 and that the \$365 deficit resulted from losses of \$1365 after June 30, the result would be markedly different. The accumulated earnings and profits as of June 30 would be \$1,500 (\$500 plus \$1,000) and the entire \$1,000 distribution would be taxed as ordinary income. See Zarky & Biblin, *supra* note 20, at 163-64.

The following are two situations in which the shareholder might prefer the redemption to be taxed as a section 301 distribution rather than to receive section 302 capital gain treatment. (1) The shareholder of the redeemed stock is a corporation entitled to the dividends received deduction of section 243. The tax on a section 301 distribution may be less painful than the capital gain tax on a sale or exchange. See, e.g., *Pacific Vegetable Oil Corp. v. Comm'r*, 251 F.2d 682 (9th Cir. 1957). (2) The redeeming corporation has no earnings and profits. A section 301 distribution is taxed as ordinary income to the extent of the corporation's earnings and profits. Since the corporation has no earnings and profits, the distribution is first applied to reduce the shareholder's aggregate basis for all his stock, including both redeemed and retained shares. Any excess is taxed at the capital gains rate. However, if the redemption were treated as a sale or exchange under section 302, the taxpayer would realize capital gain to the extent the distribution exceeds the basis of the redeemed shares.

43. I.R.C. § 316(a).

44. I.R.C. § 301(c)(1) & (2).

stockholder's basis in his shares, it is allowed capital gain treatment.⁴⁵

2) *Effect of Redemptions on Earnings and Profits*

The corporation's earnings and profits account reflects the impact of the distribution on the stockholder. If it is treated as a section 301 dividend distribution, the account is decreased by the amount of money, the principal amount of corporate obligations and the adjusted basis of other property distributed by the corporation.⁴⁶ If, on the other hand, it is treated as a section 302(a) sale of redeemed stock, the Code provides that that portion of the distribution which is "properly chargeable to capital account" shall not be considered a distribution of earnings and profits.⁴⁷ After the amount "properly chargeable to capital account" has been ascertained and deducted, the balance of the distribution reduces earnings and profits in accordance with the general rule of section 312(a).⁴⁸

As with "earnings and profits," there is no statutory language which provides a concise definition of the amount "properly chargeable to capital account." The "capital account" is generally defined as consisting of the basis of all contributions to capital, with proper adjustments for terminal distributions (*e.g.*, redemptions) and non-terminal distributions (*e.g.*, dividends) in excess of earnings and profits.⁴⁹

[A]n indirect function of the capital account lies in separating out the tax cost to the corporation of the property contributed to it by its shareholders, thereby assuring that dividend . . . treatment is confined to the subsequent gains realized and recognized by the corporation itself, *i.e.*, its earnings and profits.⁵⁰

The amount "properly chargeable" has been judicially established in the case of a distribution made in a section 302 redemption as the amount of capital allocable pro rata to the shares being redeemed.⁵¹ Thus, if a corporation redeems ten percent of its stock, the capital account is reduced by ten percent and any

45. I.R.C. § 301(c)(3).

46. I.R.C. § 312(a).

47. I.R.C. § 312(e).

48. I.R.C. § 312(a) is modified in its application by I.R.C. § 312(b) & (c).

49. See Edelstein & Korbel, *supra* note 30, at 511-12.

50. *Id.* at 517.

51. See *Helvering v. Jarvis*, 123 F.2d 742, 745 (4th Cir. 1941) *aff'g* William D. P. Jarvis, 43 B.T.A. 439 (1941), *acquiesced in* 1942-2 Cum. BULL. 10; *Woodward Inv. Co.*, 46 B.T.A. 648, 651-52 (1942), *acquiesced in* 1942-2 Cum. BULL. 20; *August Hurrmann*, 34 B.T.A. 1178, 1186 (1936).

amount in excess of ten percent of the capital account reduces the corporation's earnings and profits account.⁵²

The Regulations make it clear that the purpose of section 312(e) is to determine the earnings and profits available for future corporate distributions.⁵³ Irrespective of the treatment of the redeeming corporation's earnings and profits account, the shareholder being redeemed is still taxed as having received a capital gain or capital loss. Thus, a qualifying redemption of a relatively small percentage of the corporation's outstanding stock can effectively eliminate the corporation's earnings and profits—while the shareholder is taxed at capital gain rates—and can permit the corporation to make non-dividend distributions to the stockholders, avoiding ordinary income treatment of the remainder.⁵⁴ Section 311(d) may deter these transactions. When a corporation redeems stock with appreciated property, the gain recognized will increase the corporation's earnings and profits and provide a larger fund—"dividend" distributions which will result in ordinary income to the distributee shareholder.

3) *Distributions of Appreciated Property*

Arguably, the legislative intent of section 311(d) should be extended to apply to any distribution of appreciated property. The genesis of the problem regarding distributions of appreciated property stems from *General Utilities & Operating Co. v. Helvering*.⁵⁵ General Utilities distributed appreciated property to its shareholders and the Court held that the company realized no taxable gain. Despite the fact that the holding of the case has been attacked as uncertain,⁵⁶ the case generally has been taken to stand for the proposition that a corporation realizes no income from a distribution of property which has appreciated in value.⁵⁷

The problem arose in a slightly different context in the cases of *Commissioner v. Hirshon Trust*⁵⁸ and *Commissioner v. God-*

52. See Edelstein & Korbel, *supra* note 30, at 514. For an analysis of the "pro-rata" approach see *id.* at 513-20.

53. Treas. Reg. § 1.312-5 (1955).

54. See Zarky & Biblin, *supra* note 20, at 173-74.

55. 296 U.S. 200 (1935).

56. See R. PAUL, *SELECTED STUDIES IN FEDERAL TAXATION* 173 (2d Series 1938); Paul, *Ascertainment of "Earnings and Profits" for Purposes of Determining Taxability of Corporate Distributions*, 51 HARV. L. REV. 40, 55-57 (1937).

57. For a collection of cases following this decision see Molloy, *Some Tax Aspects of Corporate Distributions in Kind*, 6 TAX L. REV. 57, 60 n.20 (1950).

58. 213 F.2d 523 (2d Cir.), *cert. denied*, 348 U.S. 861 (1954), *rev'g sub nom.* Fannie Hirshon Trust, P-H Tax Ct. Mem. ¶ 53.106 (1953).

ley's Estate,⁵⁹ where the corporation's earnings and profits were less than the amount of the distribution. The issue presented was whether the unrealized appreciation in the property distributed, although not considered in the determination of the corporation's income tax, nevertheless increased the earnings and profits account for the purpose of determining the amount of dividend income recognized to the shareholder from distribution of the asset.⁶⁰ In each case the Commissioner succeeded in persuading the court of appeals to reverse the Tax Court decisions and hold that when appreciated property is distributed as a dividend to shareholders, the unrealized appreciation in the asset increased the corporation's earnings and profits so that the distributees of the property were taxed on the full fair market value of the property received.⁶¹ In *Commissioner v. Godley's Estate* the court determined that the distribution of appreciated property "would cause a simultaneous increase and decrease in the earnings or profits by the amount of the appreciation."⁶²

The Tax Court has refused to follow the *Hirshon Trust* and *Godley's Estate* cases. In *Harry H. Cloutier*⁶³ the Tax Court held that in a distribution of appreciated property the fair market value of the distributed asset was taxable as a dividend only to the extent of current and accumulated earnings and profits, disregarding the property distributed. The excess reduced the basis of the stock in the hands of the shareholder and any further excess was taxable at capital rates. Even the *Godley's Estate* court has adopted the Tax Court's position.⁶⁴

Section 311(a) states that aside from certain statutory exceptions⁶⁵ the distribution of property cannot result in gain or loss

59. 213 F.2d 529 (3d Cir.), *cert. denied*, 348 U.S. 862 (1954), *rev'g* Estate of Ida S. Godley, 19 T.C. 1082 (1953).

60. See Zarky & Biblin, *supra* note 20, at 167.

61. The facts of the two cases seem to limit the holdings to situations where earnings and profits exceed the adjusted basis of the appreciated property, although the earnings and profits of the distributing corporation did not equal the fair market value of the dividend in kind. See generally Block, *Non-Liquidating Corporate Distributions: Effect on Income and Earnings and Profits*, N.Y.U. 17TH INST. ON FED. TAX. 267, 269 (1959).

62. 213 F.2d 529, 532-33.

63. 24 T.C. 1006 (1955).

64. See *Comm'r v. Gross*, 236 F.2d 612 (2d Cir. 1956), *aff'g* 23 T.C. 756 (1955). "It seems well settled that unrealized appreciation does not increase 'earnings and profits.'" *Id.* at 618. See also Treas. Reg. § 1.316-1(a)(2) & (3); T.D. 6152, 1952-2 CUM. BULL. 61.

65. See note 12 *supra*. Other exceptions to section 311(a) are depreciable property which is subject to recapture of depreciation under section 1245 or 1250, and property which is subject to a prior election

to the distributing corporation. Congress, however, did not intend to relieve the corporation from paying tax on income properly attributable to the corporation but received by its shareholders.⁶⁶ The Regulations provide that

the proceeds of the sale of property in form made by a shareholder receiving such property in kind from the corporation may be imputed to the corporation Moreover, where property is distributed by a corporation, which distribution is in effect an anticipatory assignment of income, such income may be taxable to the corporation.⁶⁷

The immediate sale of distributed property by a shareholder has as a practical matter the same effect as if the corporation had first sold the property and then distributed the proceeds—a third party has the property and the shareholder has cash. In view of the judicial doctrine of “substance over form,”⁶⁸ whether or not a shareholder sells the property provides an insufficient basis upon which to afford more favorable tax treatment to the transaction.⁶⁹

It has been urged that the policy behind the non-recognition of the appreciation of distributed property stems from Congress' desire to eliminate the imposition of a “double tax.”⁷⁰ As manifested by the statutory exceptions, however, including section 311(d), the Code represents a compromise between two legislative objectives: (1) taxing income property attributed to the corporation, and (2) eliminating the “double tax” treatment. The rule with respect to inventory assets provides an informative compari-

under section 341(f).

The result of the rule of section 311(a) is that normally only appreciated property will be distributed because the corporation can sell the property which has depreciated in value, recognize the loss and distribute the proceeds.

66. S. REP. No. 1622, 83d Cong., 2d Sess. 247 (1954).

67. Treas. Reg. § 1.311-1(a) (1955). See *Comm'r v. Court Holding Co.*, 324 U.S. 331 (1945) (sale, in form by shareholder, imputed to corporation); *Comm'r v. First State Bank*, 168 F.2d 1004 (5th Cir.), *cert. denied*, 335 U.S. 867 (1948) (anticipatory assignment of income). See also *United States v. Lynch*, 192 F.2d 718 (9th Cir. 1951), *cert. denied*, 343 U.S. 934 (1952); *accord*, *A.B.C.D. Lands, Inc.*, 41 T.C. 840 (1964).

68. See, e.g., *Comm'r v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *Simon v. Comm'r*, 248 F.2d 869, 875 (8th Cir. 1957).

69. See Scott, *Taxation of Corporate Distributions in Kind*, 12 STAN. L. REV. 529, 545 (1960). Scott offers several other possible alternatives to the present law governing distributions in kind—one of which is that income be imputed to the corporation, not to tax the corporation, but solely to be included in its earnings and profits as of the time of the distribution. *Id.* at 544-53.

70. See North, *Corporate Distributions of Appreciated Property—A Comment on Policy*, 36 NEB. L. REV. 528, 534-35 (1957).

son. A distribution of an appreciated inventory asset simultaneously (1) increases the earnings and profits of the distributing corporation by an amount equal to the excess of the fair market value of the asset over its adjusted basis, and (2) decreases the earnings and profits by the lower of the fair market value of such asset or the earnings and profits as so increased.⁷¹ If the *raison d'être* of section 312(b) is to close an existing loophole with respect to distribution of an appreciated inventory item,⁷² it is arguable at least that the same loophole exists with respect to a distribution of an appreciated non-inventory asset.

C. EFFECT OF CONSTRUCTIVE DIVIDEND ON EARNINGS AND PROFITS

In order for a distribution to be a "dividend" and thus require a computation of earnings and profits to determine taxable income, there must be a "distribution of property made by a corporation to its shareholders out of its earnings and profits."⁷³ The established criteria do not require that the distribution be made pursuant to a formal declaration of a dividend, that it be in proportion to stockholdings, or that all shareholders participate in the distribution.⁷⁴ Due in part to the lack of statutory specificity, the courts have developed the doctrine of "disguised" or

71. I.R.C. § 312(b). The reason for applying the lesser of fair market value or earnings and profits as increased by the appreciation is to avoid creating a deficit in earnings and profits. For example, corporation X distributes property to individual shareholder A. The property has a fair market value of \$150 and a basis of \$75. X has earnings and profits of \$100. If the distributed property was a non-inventory asset, X's earnings and profits would be reduced by \$75, the adjusted basis of the asset. I.R.C. § 312(a)(3). A would get dividend treatment of \$100. If the distributed property was an inventory asset, X's earnings and profits would increase by the unrealized appreciation in value of the asset or \$75. I.R.C. § 312(b)(1)(A). However, in this situation, A has dividend income of \$150, since X's earnings and profits (\$175) are sufficient to cover the fair market value of the distributed property. After distribution, the earnings and profits are decreased by the fair market value of the inventory asset (\$150). I.R.C. § 312(b)(1)(B)(i). Thus, the earnings and profits remaining after distribution of either the inventory or non-inventory asset are the same. See Zarky & Biblin, *supra* note 20, at 168.

72. See S. REP. No. 1622, 83d Cong., 2d Sess. 248-49 (1954); Block, *supra* note 61, at 274.

73. I.R.C. § 316(a). See *Comm'r v. Makransky*, 321 F.2d 598, 601 (3d Cir. 1963); *Gurtman v. United States*, 237 F. Supp. 533, 537 (D.N.J.), *aff'd*, 353 F.2d 212 (3d Cir. 1965).

74. See *Comm'r v. Makransky*, 321 F.2d 598, 601 (3d Cir. 1963); *Lengsfeld v. Comm'r*, 241 F.2d 508, 511 (5th Cir. 1957); *Paramount-Richards Theatres, Inc. v. Comm'r*, 153 F.2d 602, 604 (5th Cir. 1946); *Irving S. Federbush*, 34 T.C. 740, 750 (1960).

"constructive" dividends.⁷⁵ The determinative test in ascertaining whether a constructive dividend exists is whether the transaction was merely a disguise for distributing corporate assets to a shareholder because of his status as a shareholder.⁷⁶ Thus, it appears that every corporate distribution to a shareholder potentially is subject to dividend treatment by the Commissioner.

These transactions, however, may be attacked by the Commissioner alternatively on theories of anticipatory assignment of income, tax avoidance, or clearer reflection of income.⁷⁷ The result may be both income to the corporation and ordinary income to the shareholder irrespective of earnings and profits.⁷⁸ Thus, the significance of the corporation's earnings and profits account may depend upon how the Commissioner characterizes the transaction.

Where a stockholder receives money or property from his corporation, the courts hold that he derives taxable income as a result thereof. In some cases . . . the courts hold that the income is a taxable dividend to the extent of the corporation's earnings and profits available for distribution to its stockholders. In other cases . . . the courts, viewing the matter from the standpoint of what the stockholder has actually gotten, hold that the full amount derived by the stockholder is taxable income, irrespective of the earnings and profits position of the corporation.⁷⁹

75. See, e.g., *Simon v. Comm'r*, 248 F.2d 869, 873 (8th Cir. 1957). A constructive dividend may be defined as a transfer of economic benefits from a corporation to a shareholder which in form does not resemble a dividend. Toll, *Constructive Dividends*, 1951 S. CAL. TAX INST. 211.

76. See Teschner, "Hidden Dividends"—*The Paper Tiger of Constructive Corporate Distributions*, 43 TAXES 644, 651 (1965). This article contains a good discussion of typical distributions to a shareholder which constitute constructive dividends.

77. "[T]here is much overlap, as respects corporate distributions, of cases sounding in assignment of income, tax benefit, and proper principles of tax accounting [A]ll the cases involve the search for a result that will 'clearly reflect income'" Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case*, 14 S. CAL. TAX INST. 47, 212 (1962); see I.R.C. § 446(b). See also Mintz & Plumb, *Dividends in Kind—The Thunderbolts and the New Look*, 10 TAX L. REV. 41 (1954); Note, *The Imputed Sale and Anticipatory Assignment of Income Doctrines: Their Effect on IRC §§ 311 & 336*, 15 BUFF. L. REV. 154 (1965).

Usually, a presumption of validity attaches to a determination by the Commissioner, and if a taxpayer wishes to attack such determination, he has the burden of overcoming the presumption. *Wiese v. Comm'r*, 93 F.2d 921, 923 (8th Cir. 1938). See Rice, *Tax, Fact and Fiction: Presumptions in Tax Cases*, 1 S.D.L. REV. 56 (1956).

78. See text accompanying note 77 *infra*.

79. *Elmer J. Benes*, 42 T.C. 358, 378 (1964), *aff'd per curiam*, 355 F.2d 929 (6th Cir.), *cert. denied*, 384 U.S. 961 (1966).

For purposes of stockholder taxation, the Commissioner's argument would seem to depend upon whether in a constructive dividend there were sufficient earnings and profits to produce ordinary income. If sufficient, the shareholder under either theory would incur the same amount of tax. The only difference would be that in a constructive dividend case, unlike the other theories, there is a reduction of earnings and profits which may affect subsequent distributions. In a constructive dividend case involving appreciated property, the amount of the dividend should be considered as a simultaneous increase and decrease of earnings and profits.

The Commissioner's alternate argument, "taxable income irrespective of earnings and profits," is generally asserted only where there are insufficient earnings and profits to support a constructive dividend argument. For example, in *Elmer J. Benes*⁸⁰ the taxpayer was the sole shareholder of a construction company which incurred costs in excess of its earnings and profits in constructing the shareholder's own residence. The Tax Court determined that the full construction costs were taxable income to the taxpayer irrespective of earnings and profits.⁸¹

In *58th Street Plaza Theatre, Inc. v. Commissioner*,⁸² the taxpayer, a family-held corporation, executed a sublease of a theatre to one of its stockholders. The court determined that the sublease served no business purpose, was lacking in bona fides, was designed to avoid taxes, and that the whole arrangement should be disregarded for income tax purposes.⁸³ The court held that the income which the shareholder-lessee netted from the theatre operations was taxable both as income to the corporation and as dividends from the corporation to the lessee despite the fact that the other shareholders did not receive proportionate payments.⁸⁴ The court's holding resulted in a simultaneous increase and decrease in earnings and profits and consequent ordinary income treatment to the shareholder.

The diversion of corporate funds by shareholders for their

80. *Id.*

81. *Cf. Henry C. Beck Co.*, 52 T.C. 1 (1969).

82. 16 T.C. 469 (1951), *aff'd*, 195 F.2d 724 (2d Cir.), *cert. denied*, 344 U.S. 820, *rehearing denied*, 344 U.S. 882 (1952).

83. 16 T.C. 469, 475-76 (1951), *aff'd*, 195 F.2d 724, 725 (2d Cir. 1952).

84. *See United States v. 58th Street Plaza Theatre, Inc.*, 287 F. Supp. 475 (S.D.N.Y. 1968), where the court held that the 1951 Tax Court determination with respect to a 1943 transaction was controlling with respect to 1944 and 1945 income from the theatre operation in view of proof demonstrating that the material facts in such years were identical in 1943.

own personal use has not been uniformly treated by the courts. The Tax Court has on occasion adopted the Commissioner's view that the amounts of such diversions constitute ordinary income to the shareholder regardless of whether they might be treated as a constructive dividend, and that taxability to the shareholder does not depend upon the existence of corporate earnings and profits.⁸⁵ *Simon v. Commissioner*⁸⁶ held that the amount of such diversions should be treated as a constructive dividend. A family-held corporation failed to report profits from black market operations. The income from the black market sales was diverted by the individual shareholders and used for their own personal benefit. The Tax Court held that the unreported income was taxable income to the corporation and also ordinary income to the shareholders. On appeal, the Eighth Circuit Court of Appeals held that the Tax Court's determination that the diverted funds should be treated as ordinary income was wrong. The court ruled that corporate income diverted by a controlling shareholder should be treated as taxable income to the corporation and as a constructive dividend to the shareholder—taxable at ordinary rates only to the extent of previously accumulated earnings and profits. The conclusion that ordinary income treatment is wrong seems unwarranted. The income—taxable as income to the corporation—should create a simultaneous increase and decrease in earnings and profits such that the dividend treatment would result in full ordinary income to the shareholder in any event.

The "diversion of funds" cases seem to turn on two factors: (1) whether or not the Commissioner argues for constructive dividend treatment, and (2) whether the case is a civil suit instituted after a criminal proceeding. If there are no earnings and profits or if they are insufficient to cause ordinary income to the shareholder, the controlling principle usually urged by the Commissioner is that the

amounts of corporate funds diverted by the dominant stockholder of a corporation constitute income to him regardless of whether they might be treated as a constructive dividend and that taxability to the stockholder need not turn upon the existence of corporate earnings and profits.⁸⁷

85. See, e.g., *Elmer J. Benes*, 42 T.C. 358 (1964), *aff'd per curiam*, 355 F.2d 949 (6th Cir.), *cert. denied*, 384 U.S. 961 (1966); *Patsy F. DiZenzo*, P-H Tax Ct. Mem. ¶ 64.121 (1964), *rev'd*, 348 F.2d 122 (2d Cir. 1965); *Paul V. Weir*, P.H. Tax Ct. Mem. ¶ 58.158 (1958), *aff'd*, 283 F.2d 675 (6th Cir. 1960).

86. 248 F.2d 869 (8th Cir. 1957).

87. *DiZenzo v. Comm'r*, 348 F.2d 122, 125 (2d Cir. 1965). In one

If sufficient earnings and profits are available, the Commissioner seems content in urging the constructive dividend theory to obtain his desired result of ordinary income treatment to the shareholder.⁸⁸

Where a civil action is instituted after criminal proceedings, the Commissioner will urge ordinary income treatment of the full amount of the diverted funds, regardless of the corporation's earnings and profits.⁸⁹ This position has been expanded and accepted by some courts even where a criminal conviction for tax evasion was not obtained⁹⁰ and thoroughly rejected by others.⁹¹ The Commissioner's rationale for not treating the diversion as a constructive dividend is that through his fraudulent transactions the taxpayer-shareholder has obtained complete control over the diverted funds and a consequent economic benefit which conceivably would have escaped all taxation "had it not been for the discovery of the fraud on the revenue which he was perpetrating."⁹² The Sixth Circuit is the leading jurisdiction

case, the Commissioner seemed content to tax only a portion of the funds diverted by the shareholder as dividend income. He taxed the rest as a long term capital gain. Such an allocation is questionable because nothing in the record indicated that the taxpayer's basis in his stock was zero. Nevertheless, the petitioning taxpayer did not dispute the Commissioner's allocation and the issue was never decided by the court. Irving S. Federbush, 34 T.C. 740, 754 (1960), *aff'd per curiam*, 325 F.2d 1 (2d Cir. 1963).

88. "We have held time and again . . . that the diverted funds are taxable as income to the corporation and are taxable as dividends to the extent of earnings and profits to the [stockholders] receiving them." United Mercantile Agencies, Inc., 23 T.C. 1105, 1112 (1955), *aff'd sub nom.* Drybrough v. Comm'r, 238 F.2d 735 (6th Cir. 1956). *Accord*, Eugene Vassallo, 23 T.C. 656 (1955); Michael Potson, 22 T.C. 912 (1954), *aff'd sub nom.*, Bodoglau v. Comm'r, 230 F.2d 336 (7th Cir. 1956); Bennett E. Meyers, 21 T.C. 331 (1953).

89. *See* Elmer J. Benes, 42 T.C. 358, 372-73 (1964), *aff'd per curiam*, 355 F.2d 929 (6th Cir.), *cert. denied*, 384 U.S. 961 (1966); *accord*, DiZenzo v. Comm'r, 348 F.2d 122 (2d Cir. 1965); Charles R. Leaf, 33 T.C. 1093 (1960), *aff'd per curiam*, 295 F.2d 503 (6th Cir. 1961); Simon v. Comm'r, 248 F.2d 869 (8th Cir. 1957); Davis v. United States, 226 F.2d 331 (6th Cir. 1955), *cert. denied*, 350 U.S. 965 (1956); Shlens, *Are Earnings and Profits a Necessary Prerequisite to Treatment of a Corporate Distribution as Ordinary Income?*, 45 TAXES 301, 305 (1957).

90. *See, e.g.*, Weir v. Comm'r, 283 F.2d 675, 684 (6th Cir. 1960), *aff'g* P-H Tax Ct. Mem. ¶ 58.158 (1958); *cf.* United States v. Goldberg, 330 F.2d 30, 38 (3d Cir.), *cert. denied*, 377 U.S. 953 (1964).

91. DiZenzo v. Comm'r, 348 F.2d 122, 126 (2d Cir. 1965); Simon v. Comm'r, 248 F.2d 869, 873 (8th Cir. 1957); Bernstein v. United States, 234 F.2d 475, 482 (5th Cir.), *cert. denied*, 352 U.S. 915 (1956). *See* Demmon v. United States, 321 F.2d 203 (7th Cir. 1963).

92. Davis v. United States, 226 F.2d 331, 335 (6th Cir. 1955), *cert. denied*, 350 U.S. 965 (1956).

adopting the Commissioner's theory of ordinary income irrespective of earnings and profits in civil cases which follow a criminal conviction and in some ordinary civil cases.⁹³ The majority of jurisdictions tend to view shareholders' diversions as a constructive dividend.⁹⁴ However, the burden of proving that the corporation does not have earnings and profits equal to the amounts diverted, and therefore insufficient to require ordinary income treatment, is placed upon the taxpayer-shareholder.⁹⁵ Thus, the result of either theory may be the same, i.e., ordinary income treatment to the full extent of the funds diverted. In *DiZenzo v. Commissioner*,⁹⁶ for example, the Tax Court upheld the Commissioner's contention that the amounts were ordinary income irrespective of earnings and profits. On appeal, the Second Circuit Court of Appeals held that the diversions were a constructive dividend and remanded to allow the taxpayer to prove that the earnings and profits were not equal to the amounts diverted. The taxpayer failed to carry this burden and had to include the full amount as ordinary income.⁹⁷

The existence of the two theories regarding diversion of corporate funds—ordinary income irrespective of earnings and profits and constructive dividends—adds only confusion to an area where consistency is particularly desirable. As illustrated, the

93. *Weir v. Comm'r*, 283 F.2d 675, 684 (6th Cir. 1960). See discussion of *Weir* in *DiZenzo v. Comm'r*, 348 F.2d 122, 126 (2d Cir. 1965). The case of *Drybrough v. Comm'r*, 238 F.2d 735 (6th Cir. 1956), *aff'g* *United Mercantile Agencies, Inc.*, 23 T.C. 1105 (1955), provides an interesting contrast. Because sufficient earnings and profits existed, the Commissioner urged constructive dividend treatment of the diverted funds despite the fact that this was a civil case following a criminal conviction for tax evasion. Accounting procedures adopted by the court, however, resulted in a reduction of earnings and profits such that the desired result of ordinary income treatment to full amount of diverted funds was not achieved. Apparently the court was persuaded in allowing these reductions because of the fact that the corporation was taxed on the amount of the diverted funds, and also incurred a 95 percent excess profits tax because of the inclusion into income. *Id.* at 740. The *Drybrough* case was distinguished in *Weir*, *supra* at 684. The Tax Court adopts the Commissioner's position, at least with respect to civil cases which follow a criminal conviction. See cases cited in note 89 *supra*.

94. See note 91 *supra*.

95. *DiZenzo v. Comm'r*, 348 F.2d 122, 127 (2d Cir. 1965); *accord*, *Simon v. Comm'r*, 248 F.2d 869, 877 (8th Cir. 1957); *Max P. Lash*, P-H Tax Ct. Mem. ¶ 56.087 at 365 (1956), *rev'd in part on other grounds*, 245 F.2d 20 (1st Cir. 1957).

96. 348 F.2d 122 (2d Cir. 1965), *rev'g* P-H Tax Ct. Mem. ¶ 64.121 (1964).

97. See the Tax Court memorandum decision, *Patsy F. DiZenzo*, P-H Tax Ct. Mem. ¶ 66.016 (1966).

practical difference in applying one theory rather than the other is negligible. It is difficult to imagine a shareholder proving that the earnings and profits were not equal to the amount of funds diverted since such diversions would be taxable to the corporation and included in its earnings and profits account.⁹⁸ A substantial effect on subsequent corporate distributions may result, however, depending upon which theory is applied.⁹⁹ The simultaneous increase-decrease of earnings and profits theory discussed above would produce two desirable results: (1) a consistent approach which would not depend upon the vagaries of the earnings and profits account, and (2) the ordinary income treatment of the full amount of the funds diverted. Neither is achieved presently under the spasmodic coexistence of the constructive dividend and income irrespective of earnings and profits rules.

IV. INTERACTION WITH SECTION 1248

A. INTRODUCTION

The foregoing discussion regarding (1) the adoption and application of section 311(d), (2) the effect of certain corporate distributions on earnings and profits, and (3) the theory of a simultaneous increase-decrease in earnings and profits, is of particular importance with respect to distributions to which section 1248 applies. Prior to the adoption of section 1248 in 1962 there was no distinction in the Code between domestic and foreign corporations with respect to taxable disposition of shares by a shareholder.¹⁰⁰ Section 1248 was designed "to incur a full United States tax at the time of realization of foreign earnings by United States shareholders."¹⁰¹

98. This may, of course, depend on the facts of the particular situation. For example, if a corporation is diverting rental proceeds in full, a reallocation to it might not create earnings and profits equal to the rent because (a) there might otherwise be a deficit in earnings and profits, or (b) deductions not presently being taken would be allowed.

99. "[C]ivil cases *per se* still largely proceed under the Code dividend rules." Shlens, *supra* note 89, at 307. Under the constructive dividend theory earnings and profits are increased and decreased, whereas under the other theory earnings and profits are only increased so that a greater amount would be available for treating subsequent corporate distributions as dividends. It is difficult to see why a shareholder who suffers a criminal fine and is taxed at ordinary income rates on the full amount of the diverted funds should suffer still further adverse tax consequences.

100. See Irell & Stone, *Understanding Section 1248—The New Tax Law Regarding Sales or Liquidations of Foreign Corporations*, U. So. CAL. 1964 TAX INST. 321, 323 (1964).

101. *Id.* at 328. "The philosophy behind IRC § 1248 is to collect a

Generally, section 1248 applies to transactions where a United States person realizes gain from (1) the sale or exchange of stock of a foreign corporation, or (2) a distribution from a foreign corporation which, under section 302 or 311, is treated as an exchange of stock. The section also applies to the sale or exchange of stock of a United States corporation formed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations.¹⁰² In such a case, the sale or exchange is treated as the sale or exchange of stock of a foreign corporation owned by the United States corporation.¹⁰³

Section 1248 provides that gain recognized from the sale or exchange of stock of a foreign corporation by a United States person after December 31, 1962, shall be included in such person's gross income as a dividend to the extent of the earnings and profits of the foreign corporation attributable to the period the stock sold or exchanged was held by such person and while the foreign corporation was a controlled foreign corporation.¹⁰⁴ The section provides a dual ownership requirement: stock sold or exchanged must be stock of a "controlled foreign corporation" and the owner must be a "United States person." A "United States person" as used in section 1248 means a citizen or resident of the United States, a domestic partnership or a domestic corporation who also owns or is deemed to own ten percent or more of the total combined voting power of all classes of stock of the foreign corporation entitled to vote.¹⁰⁵ The ten percent stock ownership requirement includes stock owned directly or indirectly and stock which is owned under constructive ownership rules.¹⁰⁶ A "controlled foreign corporation" is defined as

tax on the sale of stock of a foreign corporation because it had not been previously taxed as it would have if it had been a domestic corporation." Friedman & Silbert, *The Ultimate U.S. Tax Burden on Foreign Operations—Section 1248*, N.Y.U. 24TH INST. ON FED. TAX. 1401, 1406 n.15 (1966).

102. I.R.C. § 1248(e); see Treas. Reg. § 1.1248-6 (1964). The word "exchange" as used in the text is intended to be inclusive of distributions made under section 302 or 331.

103. For further discussion of section 1248(3) see Johnson, *Beware Ordinary Income When Selling Foreign Stock; Final Regs Show Impact of 1248*, 24 J. TAX. 180, 181 (1966). See also S. REP. No. 1881, 87th Cong., 2d Sess. 301 (example 3) (1962).

104. I.R.C. § 1248(a). See text accompanying note 107 *infra*.

105. See I.R.C. §§ 7701(a)(30) & 951(b). Any trust or estate, except a section 7701(a)(31) foreign estate or trust, is also included in the definition of a "United States person." I.R.C. § 7701(a)(30)(D).

106. I.R.C. § 958(a) & (b). See, e.g., Treas. Reg. § 1.958-1 & 2 (1966). Indirect ownership provisions in section 958 provide for attribution of ownership of voting stock held through foreign entities or related per-

a foreign corporation of which more than 50 percent of the total combined voting power of stock entitled to vote is owned or is considered as owned by such United States persons.¹⁰⁷ These ownership conditions need not exist at the time of the sale or exchange as long as they existed at any time within a five year period ending with the date of the sale or exchange.¹⁰⁸ Only those gains recognized by the United States person which are attributable to the foreign corporation's earnings and profits, accumulated in taxable years of the foreign corporation beginning after December 31, 1962, and accumulated during such periods when the corporation qualified as a controlled foreign corporation, are subject to the dividend treatment provided in section 1248.¹⁰⁹

B. EARNINGS AND PROFITS AND SECTION 1248

The computation of earnings and profits of the controlled foreign corporation is of vital importance in determining that part of the gain realized by a United States shareholder on a sale or exchange which may be subjected to ordinary income treatment under section 1248. The Code provides that the earnings and profits are to be "determined according to rules substantially similar to those applicable to domestic corporations."¹¹⁰

sons. These rules modify the traditional attribution rules under section 318. Slowinski, *Latest Decisions and Rulings on Controlled Foreign Corporations*, TUL. 15TH TAX INST. 358, 359 (1968). See Alexander, *Controlled Foreign Corporations and Constructive Ownership*, 18 TAX. L. REV. 531 (1963).

107. I.R.C. § 957(a). A foreign corporation completely owned by United States shareholders is not necessarily a controlled foreign corporation. To qualify as a controlled foreign corporation, more than 50 percent of the combined voting power of the foreign corporation must be owned by United States persons, each of whom owns or is deemed to own ten percent or more of the total combined voting power. See Friedman & Silbert, *supra* note 101, at 1402-03.

108. I.R.C. § 1248(a) (2).

109. *Id.* For example, foreign corporation X earns \$100 in both 1968 and 1969. United States shareholder A owns 40 percent of the voting stock of X in both years. United States shareholder B owns the other 60 percent during 1968 but sells his entire interest to a non-"United States person" on January 1, 1969. Therefore, X qualifies as a controlled foreign corporation during 1968 but not during 1969. If on January 1, 1970, A sells his stock, only \$40 (40 percent of 1968 earnings) of A's gain from such sale would be subject to section 1248 and result in ordinary income. See Irell & Stone, *supra* note 100, at 331 n.22. Gains not attributable to post-1962 earnings and profits are still entitled to receive capital gain treatment. *Id.* at 330.

110. I.R.C. §§ 1248(c) (1) & 964(a).

[I]n determining the character of dividends received by residents of the United States from foreign corporations, the ac-

Thus the problems which exist with respect to the earnings and profits account of a domestic corporation are also present with respect to controlled foreign corporations.

Since the earnings and profits of the foreign corporation is the key element under section 1248, much of the section and by far the greatest portion of the Regulations are devoted to various rules applicable in computing and allocating the earnings and profits to the particular shares of stock sold.¹¹¹ The section sets out certain specific exclusions from the earnings and profits account of a foreign corporation.¹¹² After the adjustments to earnings and profits are made at the corporate level,¹¹³ only that amount accumulated (1) in taxable years of the foreign corporation beginning after December 31, 1962, (2) during the period in which the stock sold or exchanged by the United States person was directly or constructively held by him and (3) while the foreign corporation was a controlled foreign corporation, and attributable to the gain recognized from the sale or exchange by such person is determinative of whether the shareholder is accorded capital gain or ordinary income treatment. The detailed procedure for determining the earnings and profits attributable to the stock sold or exchanged is set forth in the Regulations.¹¹⁴ The period during which the stockholder is deemed to own the stock sold or exchanged within section 1248 is governed by the

cumulated earnings and profits from which the dividends are paid are to be determined under American rather than foreign law

The Steel Improvement & Forge Co., 36 T.C. 265, 277 (1961), *rev'd and remanded on other grounds*, 314 F.2d 96 (6th Cir. 1963); *accord*, Edward D. Untermeyer, 24 B.T.A. 906, 912, *aff'd*, 59 F.2d 1004 (2d Cir.), *cert. denied*, 287 U.S. 647 (1932); Rev. Rul. 6, 1963-1 CUM. BULL. 126. The general procedures for computing a foreign corporation's earnings and profits are provided in the Regulations. Treas. Reg. § 1.964-1 (1964) amended by T.C. 6787 (1964), T.C. 6829 (1965) & T.C. 6995 (1969). See generally Cook, *Problems in Computing Earnings and Profits of a Controlled Foreign Corporation*, 25 J. TAX. 48 (1966).

111. The discussion in the Regulations is divided between "simple cases" and "complex cases." Treas. Reg. § 1.1248-2 & 3 (1964). Every case not satisfying each condition for application of the "simple case," Treas. Reg. § 1.1248-2(c) (1964), is treated as a "complex case." An analysis of some of the principles used in the computation of earnings and profits under the Regulations' "simple" and "complex" cases is presented in Friedman & Silbert, *supra* note 101, at 1409-28.

112. I.R.C. § 1248(d). The section also provides a special rule for the inclusion of certain additional amounts in the earnings and profits of the foreign corporation whose stock is sold or exchanged. I.R.C. § 1248(c) (2).

113. See Friedman & Silbert, *supra* note 101, at 1417-23.

114. See generally Friedman & Silbert, *supra* note 101, at 1423-25.

application of section 1223.¹¹⁵

Generally, the amount of earnings and profits attributable to stock sold or exchanged must be determined separately for each share of such stock.¹¹⁶ Only if a block of stock is sold or exchanged, and only if the amount realized and the basis and the holding period are the same for each share in the block, will the computation of earnings and profits attributable be made for the entire block of stock.¹¹⁷

The importance of the earnings and profits concept is further emphasized by section 1248(g) which provides that unless the taxpayer establishes the amount of the earnings and profits to be considered, his entire gain from the sale or exchange will be taxed as a dividend. Furthermore, the taxpayer is not allowed a foreign tax paid deduction from earnings and profits unless he affirmatively establishes the amount of foreign taxes to be taken into account.¹¹⁸ Thus the Code creates a presumption that the entire amount of the gain is taxable as a dividend unless the taxpayer establishes that earnings and profits indicate otherwise.¹¹⁹

115. Treas. Reg. § 1.1248-2(a)(1) (1964). Thus, if the shareholder's basis in stock exchanged is the same basis as it was in the hands of the person he acquired it from, the shareholder's holding period includes the period the stock was held by such other person. See I.R.C. § 1223(2).

116. Treas. Reg. § 1.1248-1(a)(1) (1964).

117. See Treas. Reg. § 1.1248-2(a), (b) & -3(a)(5) (1964). The procedure to compute the actual earnings and profits attributable to a certain block of stock sold or exchanged is to multiply the sum of the earnings and profits accumulated while the corporation was a controlled foreign corporation for each taxable year beginning after December 31, 1962, by the percentage that the number of shares in the block bears to the total number of shares of the corporation outstanding during such period. Treas. Reg. § 1.1248-2(e)(1) & (3) (1964).

Suppose, for example, that A, a United States person, purchased on January 1, 1967, 25 of the outstanding 100 shares of the sole class of stock of the controlled foreign corporation X. X uses the calendar year as its taxable year. See generally Friedman & Silbert, *supra* note 101, at 1409-11. A sells the 25 shares on January 1, 1970, and all the conditions of the Treas. Reg. § 1.1248-2(c) (1964) "simple case" are met. The earnings and profits for the taxable years 1967, 1968 and 1969 amount to \$30,000. The amount of gain realized by A, therefore, will be taxed as ordinary income (as a dividend) to the extent of \$7,500 (25% of \$30,000), the amount of earnings and profits attributable to A's stock; cf. Treas. Reg. § 1.1248-2(e)(4) (example (1)) (1964).

118. Compare I.R.C. § 1248(b)(1)(B) with I.R.C. § 1248(g). See Irell & Stone, *supra* note 100, at 339-40; Johnson, *supra* note 103, at 180.

119. Friedman & Silbert, *supra* note 101, at 1403. The taxpayer is considered to have established such amounts if he complies with the Regulations. See Treas. Reg. § 1.1248-7 (1964).

C. EXCEPTIONS AND LIMITATIONS TO SECTION 1248

The apparent harshness of ordinary income treatment under section 1248 is alleviated somewhat by exceptions and limitations provided in the section. Generally, section 1248 applies only if gain is recognized upon sale or exchange of stock in a foreign corporation.¹²⁰ Distributions in redemption of stock to pay death taxes are not affected by section 1248.¹²¹ The section does not apply to gain realized because of "boot" in a reorganization exchange;¹²² nor to any amount which is treated as a dividend, as a gain from the sale of an asset which is not a capital asset or as a short term gain under any other section of the Code.¹²³

The section provides a limitation on the tax applicable to individual shareholders of a controlled foreign corporation.¹²⁴ The individual shareholder's tax on a sale or exchange is limited to the amount of tax that the stockholder would have paid with respect to the foreign earnings if the foreign corporation had operated and been taxed as a domestic corporation, and the balance after taxes had been distributed to the individual stockholder and taxed at capital gain rates.¹²⁵ This limitation is very favorable to the taxpayer. For example: A, an individual and a United States person, organizes foreign Corporation X on January 1, 1968. A is the sole stockholder. X qualifies as a controlled foreign corporation and has earnings of \$50,000 in both 1968 and 1969. In each of these years X pays \$10,000 in foreign taxes. On December 31, 1969, foreign corporation X is liquidated and stockholder A recognizes \$80,000 gain (assuming a stock basis of zero)—net foreign earnings after foreign income taxes. If section 1248 had not been enacted, A would have paid taxes on the gain at capital gains rates, 24 percent of \$80,000, amounting to a tax lia-

120. Treas. Reg. § 1.1248-1(c) (1964). See Friedman & Silbert, *supra* note 101, at 1404-05.

121. I.R.C. § 1248(f) (1). Thus redemptions of corporate stock may be utilized to pay estate taxes and the expenses of administration. See I.R.C. § 303.

122. I.R.C. §§ 1248(f) (2) & 356. However, section 367 gives the Internal Revenue Service substantial control over reorganizations of foreign corporations.

123. I.R.C. § 1248(f) (3). There is no reason for the application of section 1248(a) because these transactions are already subject to full taxation at ordinary income rates.

124. I.R.C. § 1248(b). The limitation subsection is only applicable to individual shareholders. A separate limitation is also provided for corporate shareholders. See Treas. Reg. § 1.1248-1(d) (1964); Friedman & Silbert, *supra* note 101, at 1405-06.

125. I.R.C. § 1248(b). See Irell & Stone, *supra* note 100, at 337; Johnson, *supra* note 103, at 180.

bility of \$20,000. If A is a 70 percent taxpayer, and if section 1248(a) is applied, ignoring the limitation of section 1248(b), A would pay ordinary income taxes on the \$80,000 amounting to a tax liability of \$56,000. Under the limitation provided by section 1248(b), however, A only pays \$31,250, or approximately a 39 percent tax liability, computed as follows: the excess of United States taxes which corporation X would have paid in 1969 over taxes actually paid in 1969 is \$15,000.¹²⁶ The amount which A would have included in his gross income as a dividend under section 1248(a) is \$80,000 less the excess of \$15,000, or \$65,000. The increase in A's tax liability which is attributable to including \$65,000 in gross income as long term capital gain would be 25 percent of \$65,000 or \$16,250. Thus, the limitation on tax paid by A upon the liquidation is \$15,000 plus \$16,250 or \$31,250 as compared with the potential \$56,000 computed under section 1248(a).¹²⁷

D. IMPACT OF SECTION 311(d)

The enactment of section 1248 had a somewhat inhibiting effect on the use of foreign corporations by United States shareholders to attain personal tax advantages. Even though the ownership requirements might be satisfied, a taxpayer could avoid the operative effects of the section if he could establish the insufficiency of the earnings and profits of the corporation.¹²⁸ Prior to the 1969 Act, a foreign corporation with zero earnings and profits could redeem stock with appreciated property and the distributee shareholder would be taxed at capital gain rates because the dividend treatment provided by section 1248 applies only to *realized* earnings and profits.¹²⁹ Section 311(d) requires the foreign corporation to recognize the appreciated value of property distributed in certain redemptions.¹³⁰ The poten-

126. The 1969 United States tax liability for a corporation on \$50,000 of corporate earnings, assuming a 50 percent corporate tax rate, would have been \$25,000. Foreign taxes actually paid in 1969 amounted to \$10,000. The difference is \$15,000.

127. See Treas. Reg. § 1.1248-4(a)(4) (1964). See also example in Friedman & Silbert, *supra* note 101, at 1407.

128. I.R.C. § 1248(g).

129. See Irell & Stone, *supra* note 100, at 333; Johnson, *supra* note 103, at 182.

130. See text accompanying note 11 *supra*. Obviously the section 311(d) requirement is made applicable to the controlled foreign corporation only for purposes of ascertaining the amount of earnings and profits available for taxing United States shareholders at ordinary income rates.

tial effect is that when a foreign corporation redeems stock with appreciated property, and section 1248 is applicable, the United States shareholder will be taxed at ordinary income tax rates on his recognized gain from the redemption. However, the amount so taxed still depends on earnings and profits which are increased only by the amount by which the property appreciated while in the hands of the foreign corporation. This amount may be considerably less than the amount of gain which the shareholder recognizes from the redemption,¹³¹ so that only a relatively small proportion of the gain is taxed as ordinary income. Furthermore, certain deductions are allowed which would decrease the amount of earnings and profits available for dividend treatment.¹³² Another factor to be considered is that only those earnings and profits which are attributable to the taxpayer's redeemed shares are determinative of the extent of dividend treatment. For example, assume the earnings and profits of foreign corporation X amount to \$1,000, including a \$400 gain recognized by X from the distribution of appreciated property in a redemption. Shareholder A recognizes a gain of \$500 on the redemption of a block of 10 of 100 shares outstanding. Shareholder A can only obtain a maximum ordinary income tax liability on \$100, the other \$400 being taxed at capital gains rates.

It is clear from the foregoing that section 311(d), at best, may have only a slight effect on section 1248. The intended purpose of section 1248 is to subject gains recognized from section 1248 transactions to ordinary income treatment, with certain limitations. To maximize this result with respect to stock redeemed with appreciated property, it is submitted that in those situations where the attributable earnings and profits of the foreign corporation would be inadequate to cover the shareholder's gain, the theory of a simultaneous increase-decrease in earnings and profits ought to apply. The section 311(d) gain recognized by the

131. The amount of the shareholder's gain is the difference between the fair market value of the property distributed and his adjusted basis in the stock redeemed, whereas the amount of increase in the corporation's earnings and profits depends upon the adjusted basis in the hands of the corporation of the property distributed. I.R.C. § 1001 (a).

132. I.R.C. § 1248(d). For example, if the controlled foreign corporation qualifies for favorable "less developed country" treatment, the earnings and profits account might be further impaired. I.R.C. § 1248 (d) (3). See I.R.C. § 902(d). This exclusion was designed to encourage United States investments in less developed countries. See S. REP. No. 1881, 87th Cong., 2d Sess. 85-87 (1962); Schenk & Balkin, *Subpart G Tax Incentives for Export Trade: A Technical Analysis of Tax Haven Operations*, 54 MINN. L. REV. 245 (1969).

foreign corporation would be directly attributable to the block of stock redeemed and would result in a simultaneous increase and decrease in the earnings and profits account. Any excess section 311(d) gain would remain in the foreign corporation's earnings and profits account. If, however, the stockholder's gain exceeded that of the corporation's, resulting from the redemption of stock with appreciated property, the available earnings and profits, if any, would then be attributable pro rata to the block of shares redeemed. Thus, in the preceding example, stockholder A would have been taxed on \$460 at ordinary income rates and \$40 at capital gain rates.¹³³

V. CONCLUSION

"When we search for the meaning of 'earnings and profits,' then, we are in reality asking how a corporate transaction *should* affect the stockholder who receives a distribution of cash or property from the corporation after the transaction has occurred."¹³⁴

From this premise, it is clear that a stockholder receiving property from a stock redemption within the purview of section 1248 "should" receive dividend treatment on his recognized gain. Although the foreign corporation probably pays foreign taxes, it presumably pays no United States tax on the gain. It is reasonable, therefore, that the United States stockholder should receive maximum ordinary income treatment.¹³⁵ When section 311(d) is applicable to a section 1248 stock redemption, the theory of a simultaneous increase-decrease in earnings and profits should apply.¹³⁶

The effect of section 311(d) on such transactions will be to cause a tax at ordinary income rates on the stockholder's gain where only capital gain treatment resulted previously. The ef-

133. The \$400 gain recognized by foreign corporation X would have been attributed to the \$500 gain by shareholder A, and 10 percent of \$600, or \$60, would also have been attributed to A. This amount may be reduced if the limitation provided in I.R.C. § 1248(b) proves to be less.

134. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 154 (2d ed. 1966). For an interesting application of this premise see Henry C. Beck Co., 52 T.C. 1 (1969).

135. I.R.C. § 1248(b).

136. In some special cases this still may not amount to the maximum dividend treatment available; in computing earnings and profits, for example, a credit is given for federal income taxes paid on the gain recognized.

fect of the application of the proposed simultaneous increase-decrease rule will be to produce, in those cases where the earnings and profits attributable to the stock redeemed are insufficient to obtain full dividend treatment, a greater tax liability than would otherwise result under a literal reading of the Code.¹³⁷

137. Support for this theory is found in Rabinovitz, *Non-Liquidating Distributions in Kind: Effect of Recognition of Gain on Earnings and Profits*, 17 U.C.L.A. L. Rev. 408, 412 (1969):

The only difference to the distributing corporation between a distribution in which no gain is recognized and a distribution on which gain must be recognized, is that the corporation, in the latter case, must pay an income tax. . . . [A]ny increase in earnings and profits attributable to the recognition of gain should be regarded as having been distributed along with the property on which the gain was recognized.